# HAS THE IMPORTANCE OF FEDERAL VALUATION OF RAILROADS BEEN INCREASED OR LESSENED BY FEDERAL CONTROL OF OPERATION?

By H. B. Whaling

A report of the general secretary of the President's Conference Committee for the Federal Valuation of Railroads, dated December 31, 1917, stated that up to June 30, 1917, the government had spent about $9,000,000 and the railways approximately $16,600,000 on valuation work since the passage of the Physical Valuation Act of March 1, 1913.

Tentative valuations have been served on six carriers with a total mileage of 2,120 miles. Field and track inspection has been completed on 153 roads aggregating 61,333 miles; on 9 more roads totaling 44,017 miles this work is from 75 per cent to 100 per cent completed; it is from 50 per cent to 75 per cent finished on 9 additional lines having a mileage of 36,970 miles; and it is started but less than half done on 186 roads comprising 186,834 miles.

The field and track work is not the most difficult part of the undertaking. After the inventory is made the problem of valuation remains—what unit prices, what deductions for depreciation, etc., almost *ad infinitum.* All in all, the work is probably about one-third completed.

The question presented for discussion in this paper is—Does federal control of operation decrease or increase the importance of this great undertaking? This may best be answered by considering the possible uses of a physical valuation of railways.

A physical valuation may be used (1) to promote intelligent rate regulation, (2) to secure adequate supervision of securities issues, (3) to reach a just value in condemnation cases, and (4) to value non-paying roads for purposes of taxation.

## Physical Valuation and Rates

Intelligent control of railway rates presupposes a definite economic policy. Under private ownership and operation it is the purpose of owners to get as much as possible out of the public.

Rates are grossly discriminatory and generally extortionate. Under government regulation or government control it is intended to fix rates so as to shape the railway system to serve and promote the economic needs of the country. But what rate policy will accomplish this end?

The attempt to outline an economic policy of rate fixation leads us immediately to the law of comparative costs—nations, communities, persons should specialize in the production of those goods which they can produce relatively the cheapest. It is manifestly absurd for Iowa, for instance, to try to raise grapefruit or bananas when it can engage more productively in wheat and corn growing. It is no less absurd, save in degree only, for any community to divert its capital and labor from the most productive pursuits to those less productive. If the principle of comparative costs is operative there is secured a maximum utilization of resources—human and natural. Conversely, anything that interferes with the working out of this law induces an economic loss.

It is clear that the railways are the arteries of trade and that upon the proper functioning of them depends the economic movement of goods from one community to another. If rates, in the aggregate, are too high, internal commerce is restricted, or what is the same thing, the law of comparative costs is prevented from freely working, with the result that communities are forced to produce goods which they could otherwise get less expensively in exchange and productive agents are employed at less than the maximum advantage. By a like sign, if rates in total are too low, not enough capital will flow into the railway business and internal commerce is diminished with a resultant economic loss. Also, if rates are made too high to one community and too low to another the benefits of trade are destroyed, for if a community cannot ship goods out it cannot ship them in. Thus extortionate rates, confiscatory rates and discriminatory rates are economically bad.

The latter evil may be remedied by applying the principle of joint cost to railway tariffs: the two former give rise to the problem of valuation. It is this problem that involves the question of a physical valuation. To it attention is directed.

It will hardly be questioned, I believe, that if competition prevails the law of comparative costs will operate with the result that the maximum utilization of human and natural resources is achieved.

On the other hand, monopoly, by restricting the supply and by preventing the working out of the principle of comparative costs, signifies an economic loss. If the monopoly is a natural one it cannot be prevented by regulation, but it may be so controlled, through fixing its prices, as to secure the result, if not the fact, of competition, and it is the result of normal competition that is desirable.

Under competitive conditions it is ordinarily true that the value of a business equals the amount of capital invested in it. But otherwise, a competitive business can earn no more than a normal return on the capital actually invested in the enterprise. If we reverse the process in the case of monopoly and fix a price which allows to the monopoly no more than a normal return on investment we achieve the results of competition and secure the most productive use of economic agents.

Railways, of course, are characteristically monopolistic. Consequently, it should be a tenet of regulative policy to fix rates so as to permit the accrual of a normal net return to investment equal to what could be had in competitive businesses of a similar degree of risk. This is a full application of the doctrine of comparative costs.

The determination of investment without a physical valuation is inconceivable. Thus it becomes clear how important it is to have such a valuation. It is, of course, not contended that there are not intangible elements in valuation, but it is maintained that intelligent valuation and rate regulation are not possible without a physical valuation.

Since the aim of rate fixing is to fashion the railway system to serve economic welfare best, it can make no difference whether the government controls or only regulates the roads. Legal title would not change the nature of the economic problems involved. It is, therefore, patent that the recent action of the government in assuming control of operation, permanently or only temporarily, can have no effect on the importance of a physical valuation. From the point of view of rates, it is neither more important nor less important that the task begun should be completed.

## PHYSICAL VALUATION AND SECURITIES

Railway securities have afforded a most delectable field for financial manipulation. The Alton, the New Haven, the Rock Island and many others are classic instances. In 1898 Alton stock was

selling well above par—the surplus of the road was approximately $7,000,000 and net earnings easily large enough to maintain 8 per cent dividends. Under the "able" leadership of Mr. Harriman, in seven years, the capitalization was expanded from $34,000,000 to $114,000,000 while property to the extent of only $18,000,000 was acquired. In essence, the sound credit and excellent reputation of the Alton, built up through years of conservative management, was overcapitalized and sold to an unsuspecting public. The New Haven paid reckless prices for steam and trolley lines in the effort to create a transportation monopoly in New England with the result that it was greatly overcapitalized and its stock fell from $200 to somewhere near $50. The Rock Island regularly paid dividends out of capital, failing to set aside enough to cover depreciation because paying fancy prices to insiders for subsidiary lines. The result—the once prosperous road was swamped, nay drowned, in water of the characteristic muddy financial sort. And so on we might extend the sickening list—but enough.

In all this manipulation the public and the investor are interested. If rates are allowed high enough to pay dividends on the watered stock they are extortionate and trade is restrained. If rates are made so as to allow a return on investment without regard to the outstanding securities, dividends cannot be paid thereon, the credit of the company suffers, funds for extensions cannot be had, adequate transportation facilities cannot be furnished, and trade is diminished. In both cases the public loses. Likewise, of course, the investor is mulcted out of his investment.

Only the financial buccaneer gains. He should be made to disgorge in so far as possible—but it is high time that such manipulation be stopped and this can be done only by government supervision or control of security issues. The government may, in the case of private operation, either authorize issues or enforce publicity. The latter is probably preferable.

Whichever method is adopted makes no difference in so far as physical valuation is concerned. Proper control of securities issues requires sound accounting and sound accounting is based on physical valuation. It would not have been possible to pull off the Alton and other deals if the actual value of the property had been known and if the public had been informed of the disposition of the

proceeds of the securities sales. Physical valuation, sound accounting, publicity,—here lies the remedy for financial troubles.

It can make no difference whether the government merely supervises security issues, or takes over the roads permanently and issues its own securities, the financial problem is the same. Again, then, the necessity for having a physical valuation is not changed.

### PHYSICAL VALUATION AND CONDEMNATION

It is, I believe, usually considered that physical valuation is essential to condemnation proceedings. This is true, but not in the sense generally meant. If the government fixes rates or permits rates which give a certain earning power and consequently establish a certain market value of the railway securities, it ought in a purchase case to pay a price for the railways indicated by market value of securities (averaged over a period of years, of course) and not by physical value. It may be true that there is an element of monopoly returns in the earnings, but securities have been issued thereon, and equities have been established which it is not just to disturb. It is possible to reach the desired end by a progressive income tax and by a still more progressive inheritance tax, the proceeds of which may be used to amortize the securities representing the monopoly element in return. However, it is far from clear how pillaging the investor for the sake of the public is justifiable. But in the event that the road has been "skinned," *i.e.*, depreciation not taken care of, a physical valuation would be serviceable in condemnation cases. This question always arises—hence condemnation cases require the use of such a value.

In my estimation, the recent policy of the government in guaranteeing the net earnings averaged for a period of years is sound economically.

### PHYSICAL VALUATION AND TAXATION

For purposes of taxation, value depends primarily upon net earnings, but for non-paying roads a "dismembered selling value" is useful. This contention rests on the theory that goods should be put to the most economic use and if one railway cannot use them gainfully they should still be taxed at the price another railway, or another business of any sort, will pay for them.

By way of summary it may be reiterated that a physical valua-

tion is essential (1) to economic regulation of rates, (2) for the protection of investors, (3) in establishing a purchase price in certain cases, and (4) for the determination of a taxable value in the case of non-paying roads. With regard to the first two points especially, economic policy rests on a physical valuation. If the government only regulates railways or if the government continues to operate them as a public business its policy cannot economically be different, nor can it be successful without the means of determining investment, namely, a physical valuation. It is, therefore, necessary that the work now being done under the direction of the Interstate Commerce Commission go on to completion.